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Notes and Comments

EASIER EASEMENTS: A NEW PATH FOR CONSERVATION EASEMENT DEDUCTION VALUATION

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ABSTRACT—Conservation easements, a valuable tool in the conservationist's toolbox, have grown increasingly popular since the 1980s, when Congress introduced changes to the federal tax code making easement donations more financially attractive. And with deductions reaching hundreds of thousands, or even millions, of dollars, conservation easement deductions are big business. However, expanded incentives and loosened regulations invite abuse, especially when the tax implications are large and donated easements are hard to value. Valuation of real estate remains an inexact science, dependent on inconsistent appraisal methods and subjectivity. Conservation easements can be even more difficult to value than other easements because, by their very nature, they are often placed on a parcel of land with high idiosyncratic value. Thus, easement valuations can vary wildly and justifying a high valuation is not difficult. It should come as no surprise, then, that the Internal Revenue Service (IRS) has examined conservation easement valuations more closely in recent years. Taxpayers risk large fines while the IRS struggles to effectively identify and curb abuse. Both sides would benefit from greater predictability, and as the IRS continues its aggressive litigation, a solution is sorely needed. This Note examines in Part I conservation easements and valuation methods for federal conservation easement deductions. Part II explores recent challenges to taxpayer application of these methods and the problems with the current valuation system revealed by those cases. Finally, Part III first reviews recent proposed reforms to conservation easement deduction valuation as well as their shortfalls, and then introduces a recommendation that would simplify the valuation process as well as promote greater use of conservation easements.

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INTRODUCTION

Drive about three hours north from San Francisco on the 101 and head inland on California State Route 20 and you will find, nestled in the foothills of the North Coast Mountain Range, 882 acres of undeveloped wilderness known as the Blue Lakes Ranch.¹ Owned by Michael S. Mountanos, the ranch serves primarily a recreational purpose, including deer hunting.² Surrounded almost entirely by federally owned land, the Mountanos family can only access the property through an easement on federal land restricted to single-family use.³

In 2005, Mountanos donated a conservation easement on the ranch to the Golden State Land Conservancy.⁴ He subsequently claimed a valuation of \$4,691,500 for the easement, claiming the maximum allowed deduction of \$1,343,704 for the 2005 tax year.⁵ Mountanos carried forward the remainder of the deduction for tax years 2006, 2007, and 2008.⁶ The IRS then challenged Mountanos’s deduction, claiming a misuse of the before-

¹ *Mountanos v. Comm’r*, 105 T.C.M. (CCH) 1818, 1818 (2013).

² *Id.*

³ *Id.*

⁴ *Id.* at 1818–19.

⁵ *Id.* at 1819. A taxpayer may claim a deduction equal to the value of the donated conservation easement. 26 U.S.C. § 170(b)(1)(E) (2012). However, taxpayers are capped at a certain amount annually, the excess of which, subject to certain limitations, may be carried forward up to fifteen years. *Id.*; see also *infra* Part I.A.

⁶ Peter J. Reilly, *Conservation Easement No Deduction for Hypothetical Vineyard*, FORBES (June 5, 2013, 8:33 PM), <http://www.forbes.com/sites/peterjreilly/2013/06/05/conservation-easement-no-deduction-for-hypothetical-vineyard/> [http://perma.cc/44JT-GZHT].

and-after method of valuation.⁷ The Tax Court in 2013 accepted the IRS's arguments, finding the easement's actual value to be zero and imposing a 40% penalty on Mountanos's tax deficiency for the last three years he claimed the deduction.⁸

Mountanos's reversal of fortune—in the form of a \$1.5 million invoice from the IRS—is not uncommon. In recent years, a flurry of cases brought by the IRS has wreaked similar havoc on many taxpayers' returns.⁹ Ultimately, Mountanos ended up no worse off due to the fine, thanks to a statute of limitations relieving liability for 2005, but still faced an unexpected tax bill of over \$1 million for underpayment and penalties in tax years 2006–2008.¹⁰ Others were not so lucky.¹¹

The Mountanos case reveals deeper problems with the current conservation easement valuation regime. First, the burden of proof and other procedural rules promote an all-or-nothing valuation result: Mountanos held the burden of proving that his calculation supported his \$4.7 million valuation,¹² and his failure to meet that burden resulted in a valuation of zero and a substantial fine.¹³ Most likely, the easement was not truly valueless, but its real value may not be capable of measurement by a market-based approach.¹⁴ In fact, a predominant factor in conservation easement donation is often the worry or frustration that future owners will view the property solely through a financial lens and not properly consider its conservation value.¹⁵

⁷ Taxpayers can abuse this method by inflating the before-easement value and deflating the after-easement value to maximize the difference between the two. See *infra* Part I.B.2 and accompanying notes.

⁸ *Mountanos*, 105 T.C.M. (CCH) at 1822.

⁹ The IRS shows no sign of slowing down. As of May 2014, courts had issued decisions in over forty separate cases regarding conservation easement valuation since 2005, with eleven coming in 2013 and six in the first five months of 2014. NANCY A. McLAUGHLIN & STEPHEN J. SMALL, TRYING TIMES: IMPORTANT LESSONS TO BE LEARNED FROM RECENT FEDERAL TAX CASES INVOLVING CONSERVATION EASEMENTS 68–70 (2014). The IRS also continues to litigate conservation easements on various other technical grounds. *E.g.*, *Zarlengo v. Comm'r*, 108 T.C.M. (CCH) 155 (2014).

¹⁰ See *Reilly*, *supra* note 6. *Reilly* estimates that Mountanos saved as much as \$470,000 by claiming the conservation easement deduction in 2005, as compared to an estimated \$440,000 fine. *Id.*

¹¹ See, *e.g.*, *Gorra v. Comm'r*, 106 T.C.M. (CCH) 523, 523 (2013) (taxpayer facing a total deficiency of \$104,971 and total penalties of \$37,431); *Pollard v. Comm'r*, 105 T.C.M. (CCH) 1249, 1250 (2013) (taxpayer facing a total deficiency of \$217,482 and total penalties of \$43,497).

¹² *Mountanos*, 105 T.C.M. (CCH) at 1819.

¹³ *Id.* at 1822.

¹⁴ See *infra* Part IIC; cf. Brian Angelo Lee, *Just Undercompensation: The Idiosyncratic Premium in Eminent Domain*, 113 COLUM. L. REV. 593, 595 (2013) (“[T]here is a well-established consensus [that] . . . the fair market value standard systematically undercompensates . . . because individual owners value particular pieces of property for many personal reasons not shared by the market as a whole.”).

¹⁵ See, *e.g.*, CAMILLA M. HERLEVICH & LEE LEWIS LEIDY, CONSERVATION & HISTORIC PRESERVATION EASEMENTS TO PRESERVE NORTH CAROLINA'S HERITAGE 8 (2d ed. 2004), <http://www.coastallandtrust.org/images/CoastalLandTrust/site/home/media-library/conservation->

On a certain level, this issue fits into the same trade-off calculation inherent in all tax deductions between biasing the government or the taxpayer.¹⁶ A danger in not finding a proper balance is that downward pressure on valuation and threats of financial liability will discourage conservation easement donations. Congress's aggressive expansion of the conservation easement deduction and the concomitant increase in the creation of such easements indicates that the deduction is an important factor to landowners.¹⁷ But some taxpayers, facing this perilous labyrinth of valuation methods, may decide that claiming a conservation easement deduction is not worth the trouble.¹⁸ Of course, high-income individuals facing hundreds of thousands of dollars in tax savings quickly justify hiring tax and appraisal professionals. However, simplifying the conservation easement valuation system would open the deduction to lower-income individuals who might donate a conservation easement on their historic home or other smaller-scale properties.¹⁹ As development continues to encroach on open spaces and historic landmarks, private-sector conservation has become critical to preserving our natural and cultural resources.²⁰

The ultimate effect is that the tax code fails to realize its potential to effectively encourage donations of conservation easements.²¹ This Note begins by exploring the benefits of conservation easements, then discussing the conservation easement deduction program and outlining the various valuation methods used. Next, this Note assesses the problems that recent

historic-preservation-easement-book.pdf [http://perma.cc/NS99-XPEF] ("My sisters and I inherited the thousand-acre Cataloochee Ranch where we grew up[,] . . . one of the few remaining 'balds' or ancient mountaintop grassy ecosystems that have long graced the Southern Appalachians. . . . The ranch's appraised value doubled in a few short years and would no doubt climb higher. We had no interest in selling, but our heirs would face increasingly insurmountable pressures to sell.").

¹⁶ See *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593 (1943) (noting "the now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer"). See generally *Gregory v. Helvering*, 293 U.S. 465 (1935) (establishing the business purpose and substance over form doctrines); Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939 (2005).

¹⁷ See Zachary Bray, *Reconciling Development and Natural Beauty: The Promise and Dilemma of Conservation Easements*, 34 HARV. ENVTL. L. REV. 119, 129 (2010) ("From 1981 to 2005, the annual growth rate of private land trusts was . . . at its highest, about 16%, from 1985–1988—a period coincident with the early expansion of the federal tax deduction.").

¹⁸ See Kate B. Deal, Note, *Incentivizing Conservation: Restructuring the Tax-Preferred Easement Acceptance Process to Maximize Overall Conservation Value*, 101 GEO. L.J. 1587, 1603–04 (2013).

¹⁹ See *id.* at 1601–02.

²⁰ See LEIDY & HERLEVICH, *supra* note 15, at 5 (noting that "private conservation action is more important than ever before" in light of the North Carolina government's failure to fulfill the "Million Acre [Land Acquisition] Plan").

²¹ See generally Elliott G. Wolf, Note, *Simultaneously Waste and Wasted Opportunity: The Inequality of Federal Tax Incentives for Conservation Easement Donations*, 31 STAN. ENVTL. L.J. 315 (2012) (finding inefficiencies in the conservation easement deduction program).

litigation over valuation methods has revealed, including the uncertainty of appraisals, the risk of loss for incorrect valuations, and the current system's inability to properly capture conservation value. Finally, this Note concludes by examining recent proposals before suggesting a new approach to reduce taxpayer risk of loss and facilitate the true recognition of conservation value.

I. CONSERVATION EASEMENT DEDUCTIONS AND THEIR PURPOSE

Conservation easements can cover a wide variety of properties and serve many different purposes. The core purpose of conservation easements, however, is to protect a property from the inexorable march of development. By law, qualifying conservation easements cover either unimproved land or historic buildings.²²

The conservation easement also solves the problem of finite ownership. One cannot own a property forever, but one may wish to protect a property from destruction forever.²³ Conservation easements prevent future owners from altering the property contrary to the precepts of the easement.²⁴ Typically, a conservation easement on open land will limit or restrict all development on the land, whereas a conservation easement on a historic building usually prohibits changes to the historic character of the exterior of the building (commonly known as a facade easement).²⁵

Conservation easements can be donated, typically upon sale of the underlying property, to a land trust, preservation organization, government agency, or similar not-for-profit organization that enforces the easement against future property owners. Conservation easements “run with the land,” such that after one is donated, an individual may freely alienate the land and any future owners will be subject to the easement. Thus, so long as the organization entrusted with enforcement of the conservation easement maintains enforcement, a property is protected from development indefinitely.²⁶

The idea behind the conservation easement tax deduction is simple. Congress recognizes the need for preservation of open land and historic buildings, yet owning the land outright, or “in fee,” would be expensive and inefficient.²⁷ The conservation easement tax deduction encourages

²² See Treas. Reg. § 1.170A-14(d)(1) (as amended in 2009).

²³ See John L. Hollingshead, *Conservation Easements: A Flexible Tool for Land Preservation*, 3 ENVTL. LAW. 319, 322–23 (1997).

²⁴ See *id.* at 321–30.

²⁵ See Jess R. Phelps, *Preserving Preservation Easements?: Preservation Easements in an Uncertain Regulatory Future*, 91 NEB. L. REV. 121, 126, 128–132 (2012).

²⁶ See Jess R. Phelps, *Moving Beyond Preservation Paralysis? Evaluating Post-Regulatory Alternatives for Twenty-First Century Preservation*, 37 VT. L. REV. 113, 143–44 (2012).

²⁷ See Hollingshead, *supra* note 23, at 322. State and local land trusts conserved over sixteen million acres in 2010, yet only two million of those acres were owned outright by the land trusts. LAND

private landowners to voluntarily restrict the use of their land in exchange for a decrease in taxes owed to the federal government.²⁸ The deduction has succeeded in increasing the amount of land protected by conservation easements.²⁹ In fact, one study estimated that conservation easements held by state and local land trusts grew from 128,000 acres in 1980 (when Congress overhauled charitable tax deductions) to 8.8 million acres in 2010.³⁰

However, many commentators have recently questioned the program's efficacy in relation to its conservation goals.³¹ But even its harshest critics call for reformation of the tax incentives, not elimination, recognizing the tax code's unique role in promoting conservation.³² Although the relatively small size of the program would normally generate little attention from Congress,³³ the expiration of expanded conservation easement deduction benefits at the end of 2014 has caused supporters to rally for their reinstatement.³⁴ This unusual attention from Congress may represent an ideal opportunity for reform.³⁵

TRUST ALLIANCE, 2010 NATIONAL LAND TRUST CENSUS REPORT 5, <http://www.landtrustalliance.org/land-trusts/land-trust-census/2010-final-report> [http://perma.cc/X9U-T369].

²⁸ See Phelps, *supra* note 26, at 129.

²⁹ See Bray, *supra* note 17, at 129; see also Roger Colinvaux, *The Conservation Easement Tax Expenditure: In Search of Conservation Value*, 37 COLUM. J. ENVTL. L. 1, 19 (2012) ("[T]here is little doubt that the easement program has been effective in generating easement contributions.").

³⁰ Nancy A. McLaughlin, *Perpetual Conservation Easements in the 21st Century: What Have We Learned and Where Should We Go from Here?*, 2013 UTAH L. REV. 687, 690, 693.

³¹ See, e.g., Colinvaux, *supra* note 29, at 21–26, 31–34 ("[A]n easement's value for tax purposes is a negative value. . . . Unlike the value of other types of charitable contributions, easement value says little about the benefit to charity, or, as described here, the conservation value."); Josh Eagle, *Notional Generosity: Explaining Charitable Donors' High Willingness to Part with Conservation Easements*, 35 HARV. ENVTL. L. REV. 47, 82 (2011) (positing that the federal government "overpay[s] for the public benefits created by conservation easements" by as much as "several hundred thousand dollars" per easement); Wolf, *supra* note 21, at 324–26 ("[T]ax incentives to induce the donation of conservation easements should not increase as incomes increases.").

³² See, e.g., Colinvaux, *supra* note 29, at 47–60 (proposing the replacement of the deduction with a tiered tax credit system); Eagle, *supra* note 31, at 88–89 (proposing the conversion of conservation easements to development rights); Wolf, *supra* note 21, at 326–30 (proposing the replacement of the deduction with a refundable tax credit).

³³ Conservation easement deductions represented less than 0.5% of charitable deductions in 2010. Richard Rubin, *IRS Cracks Down on Breaks in Land of Rich Americans*, BLOOMBERG (Nov. 22, 2013, 3:07 PM), <http://www.bloomberg.com/news/2013-11-06/irs-cracks-down-on-breaks-in-land-of-rich-americans.html> [http://perma.cc/KUC-3HKC]. Despite the small number of donations, easements represented the category with the second-highest average donation per return in 2010. Pearson Liddell & Janette Wilson, *Individual Noncash Contributions, 2010*, STATISTICS OF INCOME BULL. Winter 2013, at 64, 65, available at <http://www.irs.gov/pub/irs-soi/13innoncash10.pdf> [http://perma.cc/CBJ4-TGWF].

³⁴ *The Enhanced Easement Incentive*, LAND TRUST ALLIANCE, <http://www.landtrustalliance.org/policy/tax-matters/campaigns/the-enhanced-easement-incentive> [http://perma.cc/P25B-QH4U].

³⁵ In February 2015, the House of Representatives voted 279–127 in favor of a bill to make the expanded benefits permanent, a measure also included by President Obama in his Fiscal Year 2016

A. Conservation Easement Deduction Requirements

Conservation easement deductions are permitted under 26 U.S.C. § 170, which governs all charitable deductions in the tax code. The code generally disallows a deduction for the contribution of partial interest in a property, such as an easement, unless the donation is a “qualified conservation contribution.”³⁶ Qualified conservation contributions comprise three elements: (1) a “qualified real property interest,” (2) donated to a “qualified organization” (3) “exclusively for conservation purposes.”³⁷ Conservation easements are a qualified real property interest by virtue of being a restriction on use granted in perpetuity.³⁸ (Conservation easements are not inherently granted in perpetuity but must be to qualify for the deduction.) The definitions of “qualified organization” and “exclusively for a conservation purpose” are beyond the scope of this Note and have no bearing on the analysis that follows.³⁹

As with all deductions for charitable contributions, the conservation easement deduction may be claimed by businesses and individuals alike.⁴⁰ Individuals, however, are subject to certain limitations on the amount that may be claimed in a given year.⁴¹ Conservation easements receive a special carryover treatment, whereby if the value of a conservation easement deduction exceeds the allowable amount in the first year claimed, the balance of the deduction’s value may be applied in future tax years for up to fifteen years.⁴²

B. Methods of Conservation Easement Valuation

Claiming the conservation easement tax deduction is a mostly simple affair, but requires a value to be placed on the donated easement, which may be a complex process. The intuitive answer to how a conservation easement should be valued might be to measure the value of what is conserved by the easement. Indeed, some have suggested that the program

budget. *How You Can Help*, LAND TRUST ALLIANCE (July 30, 2014), <http://www.landtrustalliance.org/policy/tax-matters/campaigns/how-you-can-help> [http://perma.cc/A5U3-TUCB].

³⁶ 26 U.S.C. § 170(f)(3)(B)(iii) (2012).

³⁷ *Id.* § 170(h)(1).

³⁸ *Id.* § 170(h)(2)(C).

³⁹ *See id.* § 170(h)(3) (definition of qualified organization); *id.* § 170(h)(4) (definition of conservation purpose); *id.* § 170(h)(5) (definition of exclusively for conservation purposes). Historic structures are subject to a variety of complicated rules for qualification and amount of deduction allowable, but do not see different treatment for valuation purposes. *See id.*

⁴⁰ *See id.* § 170(a).

⁴¹ *Id.* § 170(b)(1)(B), (b)(1)(E)(i). The ultimate effect of these rules is that, in most cases, a conservation easement deduction will not offset more than 30% of the taxpayer’s adjusted gross income.

⁴² *Id.* § 170(b)(1)(E)(ii).

be modified to better reflect the true conservation value of the easement.⁴³ However, the IRS—perhaps merely to stay consistent with the rest of the tax code—determines the value of the deduction to be the fair market value of the conservation easement at the time of donation.⁴⁴ Thus, the IRS measures the easement's value by the economic value relinquished, rather than the societal or other value created.

A number of methods are used to measure the fair market value of the donated easement. The five most common methods are described below, along with the challenges these methods present to the taxpayer and the IRS.

1. Comparable Sales Method.—Treasury regulations delineate two valid methods of determining the fair market value of a conservation easement, commonly known as the comparable sales and the before-and-after methods.⁴⁵ A plain reading of the regulation appears to make the comparable sales method mandatory when comparable sales exist.⁴⁶ Taxpayers have argued this position before, as in *Trout Ranch, LLC v. Commissioner*,⁴⁷ but no court has yet ruled definitively on the matter. The Tenth Circuit, in the *Trout Ranch* appeal, seemingly endorsed a mandatory preference for the comparable sales method,⁴⁸ but a subsequent Tax Court decision referred to the comparable sales method as merely “ideal,”⁴⁹ thus leaving the question unresolved. Ultimately, the court found the sales records used by the taxpayer to be insubstantial, rendering the question moot.⁵⁰

The *Trout Ranch* series is not unusual in that regard. Unlike other forms of real estate, comparable sales for conservation easements are difficult to find because they are typically gifted and not sold on the open market.⁵¹ The pool of comparable sales is further reduced by the preference

⁴³ See e.g., Colinvaux, *supra* note 29, at 37–38; Nancy A. McLaughlin, *Increasing the Tax Incentives for Conservation Easement Donations—A Responsible Approach*, 31 *ECOLOGY L.Q.* 1, 109–12 (2004).

⁴⁴ Treas. Reg. § 1.170A-14(h)(3)(i) (as amended in 2009).

⁴⁵ *Id.*

⁴⁶ *Id.* (“If there is a substantial record of sales of easements comparable to the donated easement . . . the fair market value of the donated easement is based on the sales prices of such comparable easements.”).

⁴⁷ *Trout Ranch, LLC v. Comm’r (Trout Ranch I)*, 100 T.C.M. (CCH) 581, 584 (2010), *aff’d*, 493 F. App’x 944 (10th Cir. 2012).

⁴⁸ *Trout Ranch, LLC v. Comm’r (Trout Ranch II)*, 493 F. App’x 944, 949–50 (10th Cir. 2012) (“[W]here a record of sales of comparable easements is available for meaningful comparison, the regulations require the appraisal be based on the comparable sales . . . method.”).

⁴⁹ *Mountanos v. Comm’r*, 105 T.C.M. (CCH) 1818, 1819 (2013).

⁵⁰ *Trout Ranch II*, 493 F. App’x at 950–51.

⁵¹ *Symington v. Comm’r*, 87 T.C. 892, 895 (1986) (“Unfortunately, since most open-space easements are granted by deed of gift there is rarely an established market from which to derive the fair

for local comparable sales because values for similar properties can vary geographically.⁵² What makes *Trout Ranch* notable is that the taxpayer, Trout Ranch, LLC, used the comparable sales method yet still did not prevail. Trout Ranch, LLC, a residential development company, sought to divide sixty-six acres of undeveloped land into residential lots, and donated a conservation easement covering 384 acres of undeveloped land to the Crested Butte Land Trust.⁵³ The taxpayer claimed a valuation of \$2,179,849 for the easement, relying on a comparison of the price of four different conservation easements sold in the same county.⁵⁴

The court rejected each of the prior sales as being insufficiently comparable for use. Three of the four easements used restricted development on 100%, 96%, and 89% of the land, respectively, whereas the Trout Ranch easement only restricted development on usable land by 45%.⁵⁵ The fourth easement, while similar in the percentage of land restricted, provided no benefit to the remaining land developed, whereas the Trout Ranch easement allowed the encumbered land to be used as communal ranch land by the residents.⁵⁶

Trout Ranch illustrates the difficulty in finding comparable sales, especially for open land. Real estate tends to be highly differentiable and idiosyncratic; the court considered such physical features as views, river access, and highway access, each slightly different for each property.⁵⁷ Conservation easements are similarly numerous in their permutations, often designed to create a specific bundle of property rights rather than a blanket prohibition on development.⁵⁸ Without a readily available pool of comparable sales, conservation easement donors must often resort to alternate methods of valuation.

2. Before-and-After Method.—Rather than attempt to submit comparable sales, most taxpayers determine the easement’s value using the alternative method outlined in the Treasury Regulations: the before-and-after method. As a “general rule,” fair market value under this method is defined as the difference between the land’s value before the donation of the conservation easement and the land’s value after the donation of the

market value.”); *see also* *Hilborn v. Comm’r*, 85 T.C. 677, 688 (1985) (rejecting the comparable sales method after finding no established market for facade easements).

⁵² *Whitehouse Hotel Ltd. P’ship v. Comm’r (Whitehouse III)*, 139 T.C. 304, 329–30 (2012), *aff’d*, 755 F.3d 236 (5th Cir. 2014) (rejecting the use of comparable sales in a national market where sufficient local comparable sales existed).

⁵³ *Trout Ranch I*, 100 T.C.M. (CCH) 581, 582 (2010), *aff’d*, 493 F. App’x 944 (10th Cir. 2012).

⁵⁴ *Id.* at 583–84.

⁵⁵ *Id.* at 585.

⁵⁶ *Id.*

⁵⁷ *Id.* at 584–85.

⁵⁸ *See id.* Proposed developments assessed by the *Trout Ranch* court included a single-family ranch, a planned housing development, and recreational land. *Id.*

conservation easement.⁵⁹ If the easement results in financial benefit to the donor, such as receiving historic preservation tax credits from a facade easement, the financial benefit is subtracted from the value of the easement.⁶⁰

For example, the taxpayer's appraiser in *Scheidelman v. Commissioner* valued her brownstone row house in the historic Fort Greene neighborhood of Brooklyn at \$1,015,000.⁶¹ Scheidelman wished to donate a facade easement on the building to the National Architectural Trust that would prohibit alteration of the facade and require the owner to maintain the facade.⁶² The appraiser valued the row house with such restrictions at \$900,000.⁶³ The value of the conservation easement deduction was thus the difference between the two valuations, or \$115,000.⁶⁴

Under this method, the taxpayer has two opportunities to increase the amount of the conservation easement deduction by either inflating the before-value or deflating the after-value. Easements are often placed on historic buildings or other land that requires specialized appraisal skills to reach an accurate before-value, and the extremely limited market for development restrictions makes calculating the after-value reliant on guesswork.⁶⁵ Of course, the IRS has the same opportunities to show a decreased value in the deduction.

When appraising a property's before-value, one must consider the value of the property at its highest and best use.⁶⁶ Such a use may differ greatly from its actual use, such as in *Mountanos*, and provides an opportunity for the taxpayer to inflate the appraisal value of the property. Mountanos claimed a high before-valuation, arguing that the land in question, while currently used only for recreation, could be put to more valuable use as a vineyard.⁶⁷ The courts presume that the current use is the highest and best use,⁶⁸ and the burden is on the taxpayer to show that an alternative use is "close[] in time" and "reasonabl[y] probab[le]."⁶⁹ Mountanos needed to show a higher and better use because the donated easement did not restrict the contemporaneous recreational use.⁷⁰ The court found that creating a vineyard would not be possible because of other

⁵⁹ Treas. Reg. § 1.170A-14(h)(3)(i) (as amended in 2009).

⁶⁰ *Id.*

⁶¹ *Scheidelman v. Comm'r (Scheidelman II)*, 682 F.3d 189, 192 (2d Cir. 2012).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ Phelps, *supra* note 25, at 148–49.

⁶⁶ Treas. Reg. § 1.170A-14(h)(3)(ii) (as amended in 2009).

⁶⁷ *Mountanos v. Comm'r*, 105 T.C.M. (CCH) 1818, 1820 (2013).

⁶⁸ *United States v. L.E. Cooke Co.*, 991 F.2d 336, 341 (6th Cir. 1993).

⁶⁹ *Hilborn v. Comm'r*, 85 T.C. 677, 689 (1985).

⁷⁰ *Mountanos*, 105 T.C.M. (CCH) at 1820.

restrictions placed on the land, including the lack of a permit to divert water from a nearby creek and a preexisting contract with the county to restrict development.⁷¹ Thus, because there was no difference in use before and after the easement, there was no difference in the property's value, giving the conservation easement deduction a value of zero.⁷² As discussed in greater detail below, the "closeness in time" requirement is at odds with the perpetual nature of conservation easements, and ignores the ability of parties to take future actions, such as obtaining a water permit or breaching a contract.

Treasury regulations specify that the after-valuation must consider the highest and best use after the conservation easement, which may give a different value than the before-valuation's highest and best use or current use.⁷³ This requirement was an issue in *Whitehouse Hotel Ltd. Partnership v. Commissioner*, where the taxpayer placed conservation easements on two adjacent historic buildings in downtown New Orleans: the Kress and the Maison Blanche.⁷⁴ After the donation, the taxpayer combined the two buildings with the intention of converting the combined properties into a luxury hotel.⁷⁵

The taxpayer structured the easements in such a way that, if the two buildings were kept separate, they could build additional floors onto the Kress building.⁷⁶ However, if combined into a single structure, the easement restrictions on the Maison Blanche would prevent construction on the Kress.⁷⁷ The taxpayer claimed a conservation easement deduction of \$7,445,000, the difference between a 780-room luxury hotel and a 720-room luxury hotel (the additional sixty rooms being the hypothetical Kress addition).⁷⁸ The Tax Court rejected the taxpayer's valuation, finding that the conservation easements on their face did not preclude the construction of additional floors on the Kress building, giving no difference in value.⁷⁹ On appeal, the Fifth Circuit found that the Tax Court erred in not considering the imminent combination of the buildings because a subsequent buyer would likely purchase both buildings and consider them a single building.⁸⁰ A corollary to *Mountanos*, the issue here is that of reasonable probability. The Tax Court thought it reasonably probable that

⁷¹ *Id.*

⁷² *Id.* at 1822.

⁷³ Treas. Reg. § 1.170A-14(h)(3)(ii) (as amended in 2009).

⁷⁴ *Whitehouse Hotel Ltd. P'ship v. Comm'r (Whitehouse II)*, 615 F.3d 321, 324–25 (5th Cir. 2010).

⁷⁵ *Id.* at 325.

⁷⁶ *Id.* at 337.

⁷⁷ *Id.*

⁷⁸ *Id.* at 325–27.

⁷⁹ *Whitehouse Hotel Ltd. P'ship v. Comm'r (Whitehouse I)*, 131 T.C. 112, 134–35 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

⁸⁰ *Whitehouse II*, 615 F.3d at 338–39.

the buildings could be sold separately, allowing for a higher and better use, while the Fifth Circuit disagreed.

The highest and best use is thus a “matter of valuation,” not a strict matter of fact.⁸¹ Determining the highest and best use of a property entails making several judgments backed by logic or intuition instead of economics or market data. Without an objective rubric, before-and-after valuation becomes much more of an art than a science, easily molded by the artistic flourishes of the appraiser.

3. *Reproduction Cost Method.*—Where the comparable sales or before-and-after methods are unavailable, taxpayers usually turn to one of three methods of valuation not explicitly endorsed by the IRS but sometimes successful in the courts. The reproduction cost method is one that can be used when the conservation easement encumbers a historic building.⁸² The reproduction cost method is simply the calculation of what it would cost to reproduce a historic building. The courts disfavor this method because it “almost invariably tends to inflate valuation.”⁸³ This is because the cost of reproduction determines the maximum price of a structure, not necessarily the fair market value, which would likely be lower due to negotiation, competition, and desired rates of return on investment.⁸⁴ Further, the reproduction method is inappropriate where the building would not be reproduced if destroyed.⁸⁵ Although this seems overly literal on first read, the reproduction cost would, by definition, be higher than the maximum market value if no one would be willing or required to rebuild the structure.

The reproduction cost method is allowed in a small number of cases but is limited to those in which reproduction cost is the only method that will yield a useful result.⁸⁶ Such situations arise “when the property to be valued is unique [and] its market limited.”⁸⁷ To succeed, a taxpayer must also show that reproduction would represent a “reasonable business venture”⁸⁸ and that the reproduction value would meaningfully correspond

⁸¹ *Id.* at 339.

⁸² *Losch v. Comm’r*, 55 T.C.M. (CCH) 909, 915 (1988).

⁸³ *United States v. Benning Hous. Corp.*, 276 F.2d 248, 250 (5th Cir. 1960) (footnote omitted); *see also Losch v. Comm’r*, 55 T.C.M. (CCH) 909, 915 (1988) (“However, in dealing with an older, historic structure, it is highly questionable whether the replacement cost method can be used to provide meaningful results.”).

⁸⁴ *See Benning*, 276 F.2d at 250.

⁸⁵ *United States v. Toronto, Hamilton & Buffalo Navigation Co.*, 338 U.S. 396, 403 (1949); *see also Whitehouse III*, 139 T.C. 304, 316 (2012), *aff’d*, 755 F.3d 236 (5th Cir. 2014) (“Petitioner has failed to convince us that . . . the owners of the building would want to, or would be required to, reconstruct that 100-year-old structure if it were destroyed.” (quoting *Whitehouse I*, 131 T.C. 112, 147 (2008))).

⁸⁶ *Great Atl. & Pac. Tea Co. v. Kiernan*, 366 N.E.2d 808, 812 (N.Y. 1977).

⁸⁷ *Estate of Palmer v. Comm’r*, 839 F.2d 420, 424 (8th Cir. 1988).

⁸⁸ *Benning*, 276 F.2d at 250.

to the fair market value.⁸⁹ This extremely high burden of proof means that the reproduction cost method is rarely used and is of questionable application to conservation easement valuation.⁹⁰

4. Income Valuation Method.—The income valuation method of pricing conservation easements is also rarely employed. Under the income approach, the taxpayer calculates the discounted present value of all future cash flows that would derive from the encumbered property, but for the conservation easement.⁹¹ The value is further discounted by the application of a risk-adjusted rate of return.⁹² Essentially, this method is estimating how much income one would receive by owning the property and adjusting that downward by the time value of money and the investment risk. Similar to the reproduction cost method, this amount represents the maximum that a buyer would pay for the property, but may not accurately represent the true market value.⁹³

The income valuation method is disfavored, especially where other methods, such as comparable sales, are available.⁹⁴ Calculating the present value of all future cash flows is very much a fact-intensive endeavor.⁹⁵ The likelihood of succeeding in using this method depends largely on the reliability, predictability, and recentness of the data used.⁹⁶ Much like the before-and-after method, the income valuation method is vulnerable to the heightened predictions of an overly optimistic or imaginative appraiser.

Despite the difficulty, the income valuation method is successful in certain cases. Many of these cases involve the subdivision method, so named because it involves land that will be subdivided into several lots.⁹⁷ Generally, the lots are priced individually, their values added, and the costs of sale and development subtracted.⁹⁸ While the income expectations of undeveloped land may be more predictable, each variable calculated can still be subject to a number of different possible values, differences that can quickly compound. This can add up to multiple experts coming to very

⁸⁹ *Palmer*, 839 F.2d at 424.

⁹⁰ See *Whitehouse III*, 139 T.C. at 316 (citing RICHARD R. POWELL, *POWELL ON REAL PROPERTY* § 34A.06, 34A-54 (Michael Allen Wolf ed., 2012)).

⁹¹ See *Butler v. Comm'r*, 103 T.C.M. (CCH) 1359, 1368 (2012).

⁹² *Heck v. Comm'r*, 83 T.C.M. (CCH) 1181, 1188 (2002) (citing *Estate of True v. Comm'r*, 82 T.C.M. (CCH) 27, 83 (2001)). Essentially, the riskier the future cash flows, the less a buyer is willing to pay.

⁹³ See *Butler*, 103 T.C.M. (CCH) at 1368.

⁹⁴ See *Whitehouse I*, 131 T.C. 112, 153 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

⁹⁵ See, e.g., *id.*; *Heck*, 83 T.C.M. (CCH) at 1188–93 (devoting six pages to valuing shares of a company).

⁹⁶ See *Allison v. Ticor Title Ins. Co.*, 979 F.2d 1187, 1200 (7th Cir. 1992) (remarking that income valuation is generally dependent on too many variables to be useful).

⁹⁷ See, e.g., *Trout Ranch I*, 100 T.C.M. (CCH) 581, 585 (2010), *aff'd*, 493 F. App'x 944 (10th Cir. 2012).

⁹⁸ *E.g.*, *id.* at 592–93.

different results—none of which might be considered accurate by the court—and large tax deficiencies for the taxpayer.⁹⁹ In short, the income valuation method is difficult and only accepted as a last resort where better data is simply unavailable.

5. *Fixed Percentage Method.*—One might think that a much simpler method of valuing a conservation easement would be to apply a fixed percentage based on the average diminution in value. Indeed, taxpayers commonly attempt this method.¹⁰⁰ Despite its frequent use, the Tax Court has long held that the fixed percentage method is not a valid method of valuation.¹⁰¹ Interestingly, the Second Circuit overruled the Tax Court by upholding appraisals using the fixed percentage as “qualified”—even if unconvincing—appraisals, thus avoiding the application of penalties to the taxpayer.¹⁰²

C. Penalties for Inaccurate Valuation

Valuing a conservation easement is not only difficult and imprecise, but also significant penalties can attach when the IRS successfully challenges a taxpayer’s valuation. Upon a successful challenge, the taxpayer is first liable for any tax that would have been due above what the taxpayer paid.¹⁰³ The IRS may also pursue a 20% penalty for “inter alia, (1) negligence or disregard of rules or regulations; (2) any substantial understatement of income tax; or (3) any substantial valuation misstatement.”¹⁰⁴ The taxpayer may be further liable for a 40% penalty if the underpayment of taxes is due to a “gross valuation misstatement.”¹⁰⁵ Such a misstatement exists where the reported conservation easement valuation is at least 400% more than the determined value.¹⁰⁶ IRS

⁹⁹ See, e.g., *id.* at 590–91 (calculating an income valuation of \$4.45 million for one of the properties, in contrast to the \$5.6 million and \$3.22 million values the taxpayer and IRS calculated, respectively).

¹⁰⁰ See, e.g., *Scheidelman v. Comm’r (Scheidelman III)*, 105 T.C.M. (CCH) 1117, 1121 (2013), *aff’d*, 755 F.3d 148 (2d Cir. 2014) (“[Taxpayer’s appraiser] determined the value of the easement by applying an 11.33% discount to the value of the property. His derivation of that percentage was not based on reliable market data or specific attributes of [taxpayer’s] property, but rather on his analysis of what the courts and the IRS had allowed in prior cases.”); *Gorra v. Comm’r*, 106 T.C.M. (CCH) 523, 526 (2013) (taxpayer simply applying 11% to the before-value); *Graev v. Comm’r*, 140 T.C. 377, 394 (2013) (same).

¹⁰¹ *Scheidelman III*, 105 T.C.M. (CCH) at 1121 (citing *Nicoladis v. Comm’r*, 55 T.C.M. (CCH) 624, 629 (1988)).

¹⁰² *Scheidelman II*, 682 F.3d 189, 198–99 (2d Cir. 2012). *But see* *Rothman v. Comm’r*, 104 T.C.M. (CCH) 127, 127 (2012) (rehearing taxpayers’ case after *Scheidelman II* and rejecting an appraisal that was “identical in all material respects to the appraisal in . . . *Scheidelman*” as unqualified).

¹⁰³ 26 U.S.C. § 6211(a) (2012).

¹⁰⁴ *Pollard v. Comm’r*, 105 T.C.M. (CCH) 1249, 1255 (2013) (citing § 6662(a), (b)(1)–(3)).

¹⁰⁵ § 6662(h)(1).

¹⁰⁶ See *id.* § 6662(h)(2)(A)(ii)(I).

regulations further provide that where an easement is found to be valueless, thus making a percentage difference impossible to calculate, a gross valuation misstatement has occurred.¹⁰⁷

In recent cases, the IRS has often pursued the 40% penalty associated with a gross valuation misstatement, with varying levels of success.¹⁰⁸ This is perhaps due in part to the relative ease of reaching a value of zero. The IRS needs only to show that the taxpayer failed to shift the burden of proof either as to a higher and better use, such as in *Mountanos*,¹⁰⁹ or as to the proper application of the attempted valuation method, such as in *Trout Ranch*,¹¹⁰ and the easement is presumed valueless, automatically reaching the 400% threshold for a gross valuation misstatement. Taxpayers must be aware of the risks of failed valuations and should take steps to show reasonable, good faith reliance on a qualified professional to avoid penalties.¹¹¹

II. VALUATION PROBLEMS REVEALED BY RECENT LITIGATION

Recent cases where the IRS successfully challenged the taxpayers' reported value have highlighted the difficulties that valuation poses and the need for an alternative regime. The major flaws of the current valuation system can be grouped into three categories: (1) the complexity, imprecision, and unreliability of appraisals; (2) the cost and risk of loss from gross valuation misstatements; and (3) the failure of a market value approach to reflect true conservation value. This section concludes by assessing the scope of these problems.

A. The Uncertainty of Appraisals

Before donating a conservation easement, a taxpayer should hire a qualified appraiser to conduct an appraisal of the easement.¹¹² While a qualified appraisal is not strictly necessary, claiming a charitable deduction

¹⁰⁷ Treas. Reg. § 1.6662-5(g) (as amended in 1992); see, e.g., *Mountanos v. Comm'r*, 105 T.C.M. (CCH) 1818, 1822 (2013). Most taxpayers reach a settlement with the IRS, so it is unknown how much of the penalty is typically paid. See *infra* Part II.D.

¹⁰⁸ See, e.g., *Gorra v. Comm'r*, 106 T.C.M. (CCH) 523, 537 (2013) (upholding penalties); *Pollard*, 105 T.C.M. (CCH) at 1255–56 (rejecting the enhanced 40% penalty but upholding the 20% penalty); *Evans v. Comm'r*, 100 T.C.M. (CCH) 275, 280 (2010) (rejecting penalties).

¹⁰⁹ 105 T.C.M. (CCH) at 1822.

¹¹⁰ *Trout Ranch I*, 100 T.C.M. (CCH) 581, 583–84 (2010), *aff'd*, 493 F. App'x 944 (10th Cir. 2012).

¹¹¹ *Scheidelman v. Comm'r (Scheidelman I)*, 100 T.C.M. (CCH) 24, 31–32 (2010), *vacated*, 682 F.3d 189 (2d Cir. 2012) (declining to apply penalties because taxpayer relied on a competent, experienced appraiser and provided necessary and accurate information to the appraiser). The Tax Court declined to reconsider the penalty issue on remand. *Scheidelman III*, 105 T.C.M. (CCH) 1117, 1118 (2013), *aff'd*, 755 F.3d 148 (2d Cir. 2014).

¹¹² See 26 U.S.C. § 170(f)(11)(E) (2012) (defining qualified appraisal and qualified appraiser).

is risky without one.¹¹³ Even professional appraisals, however, can vary significantly in their results.¹¹⁴ Historic properties and other properties with idiosyncratic value or unusual features are even more susceptible to variation.¹¹⁵

A few recent cases illustrate the challenges that taxpayers may face when valuing conservation easements. Appraisals must meet a complex set of criteria,¹¹⁶ yet recent courts have accepted appraisals as qualified to varying degrees. The Second Circuit, in *Scheidelman II*, overturned a Tax Court decision rendering an appraisal unqualified because the appraiser used the fixed percentage method, which the appraiser sold as being in line with historically approved cases, viewing the appraisal instead as a permissible, if sloppy, application of the before-and-after method.¹¹⁷ The Tax Court on remand found the valuation to be inaccurate and the true value to be zero because the easement provided no restriction beyond those already enforced by the historic district in which it was located.¹¹⁸ Evidence introduced by the IRS showed that ninety-one nearly identical appraisals had been previously prepared for the National Architectural Trust.¹¹⁹ Depending on your point of view, this is either evidence of a demand for simplified valuation or the extent of possible abuse slipping through the cracks.

Complicating the matter further, the D.C. Circuit upheld a similar appraisal as qualified in *Commissioner v. Simmons*, affirming the lower court's decision to modify the percentage applied instead of rejecting it outright.¹²⁰ With little justification, the Tax Court applied a 5% reduction in value, instead of the claimed 11% and 13%.¹²¹ Thus, while a basic appraisal may be deemed "qualified," insofar as it is reasonable enough to avoid penalties, it is clear that a stricter standard must be met to prevail on the valuation amount without challenge. Comparing *Scheidelman* with

¹¹³ The tax code generally provides a safe harbor from underpayment penalties where the taxpayer acts with reasonable cause and in good faith. *Id.* § 6664(c)(1). However, the safe harbor is only available in the case of conservation easement valuations where the taxpayer based the valuation on a qualified appraisal and separately investigated the value in good faith. *Id.* § 6664(c)(3).

¹¹⁴ See Mariwyn Evans, *How Accurate are Commercial Appraisals?*, REALTOR MAG., Oct. 2011, <http://realtormag.realtor.org/commercial/conversations/article/2011/10/how-accurate-are-commercial-appraisals> [http://perma.cc/EKM8-P45K] (finding appraisals to have a greater than 12% median deviation from sale prices).

¹¹⁵ See William C. Harvey, II, *Is the Price Right?*, COM. INVESTMENT REAL EST., Jan.–Feb. 2004, at 36, 38 ("Valuing unique properties is challenging even for experienced practitioners.").

¹¹⁶ See Treas. Reg. § 1.170A-13(c)(3)(i)–(ii) (as amended in 1996).

¹¹⁷ 682 F.3d 189, 197–98 (2d Cir. 2012) (stating that an appraisal is not unqualified simply because it is "sloppy" or "unconvincing").

¹¹⁸ *Scheidelman III*, 105 T.C.M. (CCH) 1117, 1122 (2013), *aff'd*, 755 F.3d 148 (2d Cir. 2014).

¹¹⁹ *Id.* at 1121.

¹²⁰ 646 F.3d 6, 12 (D.C. Cir. 2011).

¹²¹ *Simmons v. Comm'r*, 98 T.C.M. (CCH) 211, 216–17 (2009).

Simmons, one is left to wonder whether the fixed percentage method is more palatable where the percentage applied is more modest.

Even a thorough appraisal conducted by a highly qualified appraiser does not guarantee acceptance by the courts if challenged by the IRS. In a seventy-three-page opinion, the Tax Court in *Whitehouse I* rejected the \$7,445,000 valuation submitted by the taxpayer's expert and the IRS's expert valuation of zero in favor of its own analysis, reaching a value of \$1,792,301.¹²² Both experts were certified as MAI appraisers, the highest certification available from the Appraisal Institute, yet reached extremely divergent valuations.¹²³ After the Tenth Circuit rejected the Tax Court's valuation process, the Tax Court again conducted its own analysis, reaching a value of \$1,857,716.¹²⁴ Similarly, in *Trout Ranch*, the taxpayer's expert argued for a valuation of the donated easement of \$2.2 million, while two experts for the IRS argued for a valuation of zero.¹²⁵ The Tax Court rejected all three experts' valuations and employed its own complex analysis, reaching a valuation of \$560,000.¹²⁶ On appeal, the Tenth Circuit affirmed the Tax Court's decision, finding no clear error in the Tax Court conducting its own valuation analysis.¹²⁷

These cases illustrate the risk to the taxpayer in relying on appraisals, even those conducted by top-certified experts. Undoubtedly, the divergence in valuation is exacerbated by the taxpayer's incentive to claim the largest reasonable valuation and the IRS's incentive to find a valuation of zero. But how can taxpayers know where the boundaries of reasonable valuation are without the availability of an objectively correct value? The taxpayers in *Whitehouse* and *Trout Ranch* missed the mark by about 400%; even significant reductions in claimed valuations would have been deemed incorrect by the IRS and the courts.

Rather than permit the taxpayer to submit another appraisal, the Tax Court often conducts its own valuation analysis. Commentators have criticized the Tax Court for relying too heavily on comparable sales, which are often insufficiently comparable for the "after" valuation because of unique property characteristics and the small conservation easement market.¹²⁸ Although the Tax Court is experienced and skilled in tax and valuation issues, accurate valuation data is simply unavailable. Further, it is

¹²² 131 T.C. 112, 118, 128–29, 171–72 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010). Despite its expert's testimony, the IRS contended the value of the easement to be \$1.15 million. *Id.* at 118.

¹²³ *Id.* at 118–20.

¹²⁴ *Whitehouse III*, 139 T.C. 304, 348 (2012), *aff'd*, 755 F.3d 236 (5th Cir. 2014).

¹²⁵ *Trout Ranch I*, 100 T.C.M. (CCH) 581, 583 (2010), *aff'd*, 493 F. App'x 944 (10th Cir. 2012).

¹²⁶ *Id.* at 585–93.

¹²⁷ *Trout Ranch II*, 493 F. App'x at 954.

¹²⁸ See Stephanie S. Jeane, Note, *The Façade of Valuation: Why the Whitehouse Hotel Ltd. Partnership v. Commissioner Façade Easement Valuation Method Is Not Working*, 66 TAX LAW. 501, 511 (2013).

often unclear what comparable sales should be used in the valuation analysis.¹²⁹

Resolution of valuation through the Tax Court is also problematic because of the standard of review upon appeal. Appellate courts considering conservation easement valuation cases apply a clear error standard of review to the Tax Court's decision.¹³⁰ This standard means that whereas the Tax Court is free to spend dozens of pages conducting its own valuation analysis, appellate courts are more constrained and typically only affirm or remand the case to the Tax Court for another valuation. As *Whitehouse III* shows, a remand can result in the Tax Court conducting another lengthy valuation analysis that reaches roughly the same result.¹³¹ These factual battles can last several years and use up valuable resources of the court, the IRS, and the taxpayer.¹³²

B. Cost of Appraisals and Risk of Loss Is Substantial

The uncertainty of appraisals means that taxpayers risk substantial sums by claiming a deduction for the donation of a conservation easement. The risk to the taxpayer is the cost of an appraisal that may not hold up in court, and substantial penalties that may be imposed on any deficiencies. The risk of a penalty is exacerbated when the IRS argues, as it often does, that the taxpayer's easement is without value.¹³³

When the IRS succeeds in arguing that a donated easement has no value, the taxpayer can be liable for a significant sum. In *Scheidelman*, the taxpayer paid \$9,275 to the National Architectural Trust for an appraisal of her Brooklyn home.¹³⁴ When the court eventually found the easement to hold no value, Scheidelman faced a total deficiency of \$35,425 and total penalties of \$7,085.¹³⁵ Although the court ultimately refrained from upholding the penalties,¹³⁶ Scheidelman still faced a combined tax bill and appraisal cost of \$44,700. The taxpayer faced a similar burden in

¹²⁹ See, e.g., *Whitehouse I*, 131 T.C. 112, 157–58 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010) (calculating highest and best use against local non-luxury hotels' sales instead of nonlocal luxury hotels).

¹³⁰ E.g., *Trout Ranch II*, 493 F. App'x at 951.

¹³¹ 139 T.C. 304, 348 (2012), *aff'd*, 755 F.3d 236 (5th Cir. 2014) (increasing its previous valuation of \$1,792,301 to \$1,857,716).

¹³² The *Whitehouse* taxpayers claimed their deduction in 1997, but litigation did not conclude until 2012. *Id.* at 309–10.

¹³³ See, e.g., *Scheidelman III*, 105 T.C.M. (CCH) 1117, 1122 (2013), *aff'd*, 755 F.3d 148 (2d Cir. 2014); *Trout Ranch I*, 100 T.C.M. (CCH) 581, 583 (2010), *aff'd*, 493 F. App'x 944 (10th Cir. 2012); *Simmons v. Comm'r*, 98 T.C.M. (CCH) 211, 216 (2009); see also Jeane, *supra* note 128, at 511 ("The Service often asserts the easement is valueless." (citing Scott D. McClure et al., *Courts to IRS: Ease Up on Conservation Easement Valuations*, 124 TAX NOTES 551, 555 (2009))).

¹³⁴ *Scheidelman I*, 100 T.C.M. (CCH) 24, 26–27 (2010), *vacated*, 682 F.3d 189 (2d Cir. 2012).

¹³⁵ *Id.* at 24.

¹³⁶ *Scheidelman III*, 105 T.C.M. (CCH) at 1118.

Mountanos when the IRS assessed a total deficiency and penalty liability of over \$1.5 million.¹³⁷ This sum included a 40% penalty on the taxes that would have been owed had the taxpayer not claimed the nearly \$5 million deduction spread out over several years.¹³⁸

Some might consider cases of high-income individuals' tax liability to be a minor concern. But the larger goal of conservation is threatened if such high penalties and deficiency bills are allowed. Our most valuable natural and historic resources are often those with the greatest market (and idiosyncratic) value.¹³⁹ The risk of large fines and deficiency bills, combined with the costs of appraisals and possible litigation, may cause owners of valuable historic properties or large tracts of open land to think twice about donating a conservation easement.¹⁴⁰ The easement deduction is designed to incentivize easement donations, but fails to meet that goal if the risk of deficiencies and fines negates the tax benefit.¹⁴¹

C. Valuations May Not Capture Conservation Value

A common argument made by the IRS in recent litigation over conservation easement valuations is that an easement has no value because it fails to protect the property beyond what existing laws or regulations provide. In several cases, the courts have agreed. As previously discussed, the Tax Court in *Scheidelman III* found the easement to have no value because the easement provided no restriction beyond those already imposed by the Fort Greene Historic District.¹⁴² Courts in other cases have significantly reduced easement valuations due to existing historic district restrictions.¹⁴³

Similarly, the court in *Mountanos* found a conservation easement restricting development on open land to have no value because the taxpayer

¹³⁷ See Reilly, *supra* note 6.

¹³⁸ *Id.*

¹³⁹ Cincinnati residents recently struggled to value Union Terminal and Music Hall, which were both threatened by significant deterioration and on the National Trust for Historic Preservation's 2014 "11 Most Endangered Historic Places" list. *Union Terminal*, NAT'L TRUST FOR HISTORIC PRESERVATION, <http://www.preservationnation.org/issues/11-most-endangered/locations/union-terminal.html> [<http://perma.cc/4Q75-V5GK>]; *Music Hall*, NAT'L TRUST FOR HISTORIC PRESERVATION, <http://www.preservationnation.org/issues/11-most-endangered/locations/music-hall.html> [<http://perma.cc/CBG2-R8CR>]. Auditors estimated the value of the buildings in their current state to be only approximately \$37 million combined, but supporters of a \$331 million renovation plan said that price tag didn't capture the full value to the community. Dan Horn, *Value of Iconic Buildings Hard to Measure*, CINCINNATI ENQUIRER (Aug. 7, 2014, 2:43 PM), <http://www.cincinnati.com/story/news/2014/06/22/value-iconic-buildings-hard-measure/11250727/> [<http://perma.cc/RB7K-WM8C>].

¹⁴⁰ Indeed, the number of state and local land trusts has plateaued since 2005, after twenty-five years of extraordinary growth. McLaughlin, *supra* note 30, at 689–90. While donations by acreage continue to grow, the growth rate has slowed since 2005. *Id.* at 691.

¹⁴¹ See Phelps, *supra* note 25, at 168.

¹⁴² *Scheidelman III*, 105 T.C.M. (CCH) 1117, 1122 (2013), *aff'd*, 755 F.3d 148 (2d Cir. 2014).

¹⁴³ See, e.g., *Simmons v. Comm'r*, 98 T.C.M. (CCH) 211, 217 (2009).

could not show a higher and better use beyond recreation.¹⁴⁴ Restrictions on the land imposed by the Williamson Act already prevented residential development, and federal land surrounding the Mountanos property restricted access to irrigation necessary for use as a vineyard.¹⁴⁵ The taxpayer failed to provide evidence of another feasible use, rendering the after-value equivalent to the before-value, giving the easement no value.¹⁴⁶

What these decisions fail to acknowledge is that conservation easements provide a different level of protection because of their perpetuity. Laws can be amended, defunded, or repealed;¹⁴⁷ neighboring land restrictions can be lifted or purchased away;¹⁴⁸ and historic district regulations can be inconsistent or go unenforced.¹⁴⁹ In contrast, land trusts form endowments, and easement donors are required or heavily encouraged to donate an amount necessary to cover the endowment's cost of perpetual enforcement.¹⁵⁰ While the market may take a long-term view, especially in real estate, there is a point in time where market variables become too complex to predict, yet the easement will persist. In cases where the restricting laws are unlikely to change in the near future, the perpetuity value may approach *de minimis* from a market perspective, but retain an above *de minimis* value from a conservation perspective.¹⁵¹

The market is also unlikely to capture these benefits because market failures often result in improper valuation of the true benefits of

¹⁴⁴ *Mountanos v. Comm'r*, 105 T.C.M. (CCH) 1818, 1820, 1822 (2013).

¹⁴⁵ *Id.* at 1820–21.

¹⁴⁶ *Id.* at 1822.

¹⁴⁷ In 2007, California Governor Arnold Schwarzenegger proposed cutting funding to the Williamson Act. Ramona Frances & Glenna Jarvis, *Repeal of Williamson Act Could Change the Face of Central Valley's Landscape*, MADERA TRIBUNE, July 28, 2007, <http://www.maderatribune.com/news/repeal-williamson-act-could-change-face-central-valleys-landscape> [<http://perma.cc/B3QU-3PGB>]. Had the budget cuts gone through, the contract restricting development on the Mountanos property may not have been renewed. *See id.* (“Once these contracts expire and if the County finds it cannot financially support the program, it would no longer be able to protect farms, ranches and open space from development.”).

¹⁴⁸ The IRS in *Mountanos* only contended (and the taxpayer failed to refute) that the taxpayer could not obtain the necessary water permits to build a vineyard. *Mountanos*, 105 T.C.M. (CCH) at 1820. Obtaining a water use permit may be a minor roadblock to a differently positioned developer.

¹⁴⁹ *See* JULIA FERRARI ET AL., LOCAL HISTORIC DISTRICTS OF NEW HAMPSHIRE 2 (2012), http://www.nh.gov/nhdhr/publications/documents/lhd_surveyreport2012.pdf [<http://perma.cc/ZG3Y-K7JV>] (estimating that twelve of ninety-six towns in New Hampshire abandoned their historic commissions or districts between 2006 and 2012).

¹⁵⁰ *See, e.g., Donating Conservation Easements: When Conservation Practices and Philanthropy Meet*, VT. LAND TRUST, <http://www.vlt.org/news-publications/publications-archive/archived-articles/11-donating-conservation-easements> [<http://perma.cc/FH9P-Q6TG>].

¹⁵¹ Ultimately, a valueless easement, even from a market perspective, is a legal fiction, albeit one that the courts have upheld. *Cf. Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1044 (1992) (Blackmun, J., dissenting) (challenging, in a four-justice dissent, the majority on the idea that a parcel of land is valueless simply because it is completely barred from its highest and best economic use); Richard A. Epstein, *Why Restrain Alienation?*, 85 COLUM. L. REV. 970, 972 (1985).

conservation. Any value gained through conservation is a positive externality enjoyed by the public, not necessarily the property owner. Additionally, because public funds for the purchase of conservation easements are limited, the externality is unlikely to be captured by the market price.

This point is perhaps best illustrated through a hypothetical, based on *Whitehouse*, where the court reached a valuation by comparing the Kress and Maison Blanche buildings, combined to form a luxury hotel, to nearby nonluxury hotels.¹⁵² The taxpayers claimed a deduction based on the easement's restrictions on building additional floors.¹⁵³ Imagine a similar situation involving a five-story historic hotel with a facade easement placed on the building proscribing demolition of the building and development above five floors. Before the easement, perhaps the highest and best use would be to demolish the building and construct a ten-story nonluxury hotel, giving a value of \$5 million. After the easement, perhaps the highest and best use would be to operate a five-story luxury hotel that would generate similar revenue and give an equivalent value of \$5 million. The easement would be deemed to hold no value because the market is indifferent between a ten-story nonluxury hotel and a five-story luxury hotel. The IRS would likely respond by noting that the taxpayer has donated something with no economic value and should thus not be given a tax deduction.

However, the five-story luxury hotel is producing external benefits by preserving a historic structure. Often, historic buildings are located in historic districts (with or without historic district governance) that depend on the collective preservation of historic buildings to maintain overall value. The New Orleans Vieux Carré Historic District and Canal Street Historic District depended on the preservation of the Kress and Maison Blanche buildings to help maintain the district's value,¹⁵⁴ but that external value can go unrecognized in a market-based valuation that only looks to the effect of the conservation easement on the individual building.¹⁵⁵

So why does the market fail to capture this benefit? It may be that the market fails to incorporate conservation value because the bargaining power of conservationists is so limited. If conservation benefits are second- and third-order benefits, accruing first in the above hypothetical to the Vieux Carré Historic District, then to the economic growth of New Orleans as a whole, and then to out-of-town visitors to the Historic District, the likelihood of fully capturing the conservation benefit is hindered by

¹⁵² *Whitehouse I*, 131 T.C. 112, 157–58 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

¹⁵³ *Id.* at 131–32.

¹⁵⁴ The New Orleans Central Business District Historic District Landmark Commission rated the Maison Blanche building as holding “major architectural importance.” *Id.* at 116.

¹⁵⁵ See generally Colinvault, *supra* note 29, at 34–38 (discussing the dichotomy between conservation value and lost economic value).

multiple layers of transaction costs. Ideally, market actors would have perfect information about the conservation benefits and be able to overcome collective action problems to aggregate the money needed to purchase the optimal mix of conservation easements. But it seems quite unlikely that land trusts have solved these problems. A market is only as “perfect” as the information that feeds into it. If transaction costs consistently prevent conservation “information” from entering the market, the market will consistently undervalue conservation. While the IRS might see valuation as purely an exercise in price discovery, the goals of the conservation easement deduction program are better served if external conservation value is also considered.

D. Scope of Valuation Challenges and Abuse

Naturally, the final question is how widespread are the risks to the taxpayer of IRS challenges? Although it is unclear exactly how many conservation easement deductions are challenged each year by the IRS, an examination of recent Tax Court data reveals the likelihood of significant taxpayer risk.

In 2013, the Tax Court issued an opinion for six new cases relating to conservation easement deductions.¹⁵⁶ The IRS sought gross valuation misstatement penalties in all cases except one.¹⁵⁷ In litigation, the Tax Court avoided the question of gross valuation misstatement in two cases¹⁵⁸ and found a gross valuation misstatement in three other cases.¹⁵⁹ Only in one case did the Tax Court deny the penalty, applying the reasonable cause exception, though the court applied the smaller substantial understatement penalty.¹⁶⁰

These data fail to answer how many taxpayers do not fully pursue the issue in court when they are denied deductions or assessed penalties for gross valuation misstatements. However, by extrapolating from general trends, one can reach a rough estimate. For fiscal year 2012, only 0.04% of all taxpayers receiving a notice of deficiency filed a petition with the Tax

¹⁵⁶ The Tax Court issued opinions in four additional cases in which the IRS originally argued for valuation-related penalties. Heard as rehearings per TAX Ct. R. 161: *Friedberg v. Commissioner*, 106 T.C.M. (CCH) 360 (2013); *Mitchell v. Commissioner*, 106 T.C.M. (CCH) 215 (2013); and *Carpenter v. Commissioner*, 106 T.C.M. (CCH) 62 (2013). Heard upon remand from an appellate court: *Scheidelman III*, 105 T.C.M. (CCH) 1117 (2013), *aff'd*, 755 F.3d 148 (2d Cir. 2014).

¹⁵⁷ *Belk v. Comm’r*, 140 T.C. 1 (2013); *61 York Acquisition, LLC v. Comm’r*, 106 T.C.M. (CCH) 594 (2013); *Gorra v. Comm’r*, 106 T.C.M. (CCH) 523 (2013); *Graev v. Comm’r*, 140 T.C. 377 (2013); *Mountanos v. Comm’r*, 105 T.C.M. (CCH) 1818 (2013); *Pollard v. Comm’r*, 105 T.C.M. (CCH) 1249 (2013).

¹⁵⁸ *61 York*, 106 T.C.M. (CCH) at 596–97; *Graev*, 140 T.C. at 379 n.2.

¹⁵⁹ *Gorra*, 106 T.C.M. (CCH) at 536 (finding gross valuation misstatement); *Mountanos*, 105 T.C.M. (CCH) at 1822 (same); *Pollard*, 105 T.C.M. (CCH) at 1255–56 (same).

¹⁶⁰ *Pollard*, 105 T.C.M. (CCH) at 1256.

Court.¹⁶¹ In recent years, about 2% of all Tax Court cases have actually been tried and decided, with about 80% settled and about 18% dismissed.¹⁶²

Thus, based on the above data, the six conservation easement valuation cases in 2013 would represent about 300 cases filed in the Tax Court and thousands of notices of deficiency received by taxpayers. The notice of deficiency calculation is clearly unrealistic as only 2933 taxpayers claimed the deduction in 2010, totaling \$766 million.¹⁶³ With an average deduction of over \$260,000, one can assume that taxpayers claiming the deduction are sophisticated enough to file in the Tax Court at a much higher rate than the general public and less likely to settle out of court. But even assuming a file rate of 100% instead of 0.04%, the data suggest that at least 10% of taxpayers claiming the deduction are receiving notices of deficiency and are at substantial risk of deficiency liability and gross misstatement valuation penalties.

Of course, it is possible—or even likely—that the IRS is cracking down because taxpayers are abusing the latitude inherent in appraisals.¹⁶⁴ In all three cases in 2013 where the Tax Court found a gross valuation misstatement, the IRS claimed the conservation easement to be valueless.¹⁶⁵ However, in *Pollard v. Commissioner* and *Gorra v. Commissioner*, the court found the easement to have significant value (though far less than claimed by the taxpayer),¹⁶⁶ while in *Mountanos*, the court declined to affix a value, deciding only that the taxpayer failed to prove any value.¹⁶⁷ Past cases follow a pattern similar to *Pollard* and *Gorra*.¹⁶⁸

This pattern suggests that either (1) there is a wide range of plausible values and thus taxpayer “abuse” is merely claiming the best plausible value, (2) many certified appraisers are willing to give grossly inflated values, or (3) the IRS is engaging in similar abuse in undervaluing

¹⁶¹ NAT'L TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 82 n.43 (2012), <http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Volume-2.pdf> [<http://perma.cc/9B8P-7857>].

¹⁶² See *id.* at 83.

¹⁶³ Rubin, *supra* note 33.

¹⁶⁴ Janet Novack, *Feds Sue Trust Over Historic Easement Tax Breaks*, FORBES (June 16, 2011, 1:52 PM), <http://www.forbes.com/sites/janetnovack/2011/06/16/feds-sue-trust-over-historic-easement-tax-breaks/> [<http://perma.cc/Z28E-WLJ3>] (reporting on IRS lawsuit against the Trust for Architectural Easements, claiming abusive valuation practices).

¹⁶⁵ *Gorra v. Comm'r*, 106 T.C.M. (CCH) 523, 534 (2013); *Mountanos v. Comm'r*, 105 T.C.M. (CCH) 1818, 1818 (2013); *Pollard*, 105 T.C.M. (CCH) at 1249.

¹⁶⁶ *Gorra*, 106 T.C.M. (CCH) at 536; *Pollard*, 105 T.C.M. (CCH) at 1255.

¹⁶⁷ *Mountanos*, 105 T.C.M. (CCH) at 1819 n.2.

¹⁶⁸ See, e.g., *Trout Ranch I*, 100 T.C.M. (CCH) 581, 591–92 (2010), *aff'd*, 493 F. App'x 944 (10th Cir. 2012).

conservation easements. Perhaps the Tax Court's willingness to engage in its own valuation implies that one or both of the latter two are occurring.¹⁶⁹

Strong evidence also exists that many taxpayers shopped around for favorable appraisals and then used the appraisal to shield themselves from penalties.¹⁷⁰ At least one easement-holding organization promoted appraisal shopping as no-risk to the taxpayer, even guaranteeing the return of any associated donation if the tax benefit was denied.¹⁷¹ The Tax Court's recent responses only muddy the issue, as obtaining a qualified appraisal is in some cases sufficient to avoid penalties, but in other cases, the court has required that the taxpayer conduct some additional level of investigation into the appraisal's veracity, especially if the taxpayer has some base of relevant knowledge.¹⁷² Of course the mixed case law may be attributed to the difficulty in divining which cases deserve penalties and which do not because taxpayers come with varying levels of knowledge and expertise.¹⁷³

Abuse is obviously problematic for the IRS, but should also concern conservationists. Abusive valuation spends limited resources on taxpayer windfalls instead of additional conservation and, if widespread, threatens the deduction's future. Conservationists should work with the IRS to identify ways to curb abuse without also curbing proper easement donation. Unfortunately, the uncertainty inherent in the current valuation system means the IRS will always face an uphill battle in trying to stop—or even identify—abusive valuation. A new way forward is needed, or this troubling trend of litigation will continue and is bound to harm easements as a conservation tool, if it hasn't already.

III. A NEW VALUATION PROPOSAL

Given that the current conservation easement valuation system relies on inherently inaccurate appraisals, a market-value approach that fails to fully capture conservation value, and easily abused valuation practices, it is no surprise that many writers have proposed alternatives.¹⁷⁴ While these

¹⁶⁹ It is likely no coincidence that before the IRS began targeting abusive conservation easements, the Tax Court was loath to conduct its own valuation analyses. *See, e.g., Nicoladis v. Comm'r*, 55 T.C.M. (CCH) 624, 629 (1988) (“Any judgment of our own would be tainted with the same concerns [raised by experts for both the taxpayer and the IRS].”); *Hilborn v. Comm'r*, 85 T.C. 677, 699 (1985) (acknowledging validity of taxpayer's valuation concerns but adopting IRS's valuation as “objective” rather than taxpayer's “subjective” valuation).

¹⁷⁰ Novack, *supra* note 164.

¹⁷¹ *Graev v. Comm'r*, 140 T.C. 377, 381 (2013) (discussing “side letter” sent to taxpayer by the National Architectural Trust (now Trust for Architectural Easements) offering a return of the donation if the deduction were denied).

¹⁷² *Compare Scheidelman I*, 100 T.C.M. (CCH) 24, 31–32 (2010), *vacated*, 682 F.3d 189 (2d Cir. 2012), *with Rothman v. Comm'r*, 104 T.C.M. (CCH) 127, 127 (2012).

¹⁷³ *Compare Graev*, 140 T.C. at 382 (taxpayer occupation of attorney), *with Scheidelman I*, 100 T.C.M. (CCH) at 31–32 (taxpayer is layperson).

¹⁷⁴ *See infra* Part III.A.

alternative schemes are often novel and attempt to improve promotion of conservation or reduce administration costs, none strike the appropriate balance between conservation, administration, and accuracy of value. As an alternative, this Note proposes the use of “alternative minimum value” as both a safe harbor for taxpayers and a better capture of conservation value.

A. Recent Proposals Fail to Solve Valuation Problems

1. *Tax Credits and Direct Spending.*—A common proposal is to do away with the charitable deduction donation scheme altogether and replace it with an alternative method of promoting conservation. Professor Daniel Halperin suggests replacing the deduction with a direct spending program (as opposed to the indirect “spending” from tax deductions and credits).¹⁷⁵ The direct spending would come in the form of grants to developers and target properties with greater conservation value.¹⁷⁶ However, as others have noted, a direct spending program would make already scarce resources even scarcer¹⁷⁷ and allocate those resources less efficiently.¹⁷⁸

Professor Halperin also suggests a refundable tax credit,¹⁷⁹ an idea shared by other authors.¹⁸⁰ Such proposals either explicitly state or assume that the tax credit amount would be calculated as a fixed percentage applied to the value of the property before the easement.¹⁸¹ Halperin would model conservation easement tax credits after the low-income tax credit program, which has successfully promoted affordable housing projects.¹⁸² The credits would be capped, and distribution would be determined through application to the Bureau of Land Management or state agencies.¹⁸³ Elliott Wolf proposes simply replacing the deduction with refundable, uncapped tax

¹⁷⁵ Daniel Halperin, *A Better Way to Encourage Gifts of Conservation Easements*, 70 EXEMPT ORG. TAX REV. 193, 197 (2012).

¹⁷⁶ *Id.*

¹⁷⁷ Deal, *supra* note 18, at 1608 (“A direct-spending program . . . would by political necessity involve allocation of a fixed dollar amount of funds.”). Recent pressures to cut discretionary spending across-the-board have resulted in cuts even in programs that are revenue-positive, such as IRS enforcement. Chuck Marr & Joel Friedman, *Cuts in IRS Budget Have Compromised Taxpayer Service and Weakened Enforcement*, CENTER ON BUDGET AND POL’Y PRIORITIES (June 25, 2014), <http://www.cbpp.org/cms/?fa=view&id=4156> [<http://perma.cc/SAY2-HG44>] (reporting on a Treasury study showing that every dollar invested in IRS enforcement returns six dollars to the federal government).

¹⁷⁸ Colinvaux, *supra* note 29, at 48 (“[T]he tax expenditure likely results in lower costs per acre . . . than a direct spending program.”); *see also supra* notes 27–30 and accompanying text.

¹⁷⁹ Halperin, *supra* note 175, at 197–98. Instead of decreasing the amount of income subject to tax as a deduction does, a refundable tax credit is a direct payment to the taxpayer, regardless of the level of taxable income.

¹⁸⁰ Colinvaux, *supra* note 29, at 41–46, 49–60; Wolf, *supra* note 21, at 326–30.

¹⁸¹ Colinvaux, *supra* note 29, at 49–51; Halperin, *supra* note 175, at 197–98; Wolf *supra* note 21, at 329.

¹⁸² Halperin, *supra* note 175, at 197.

¹⁸³ *Id.* at 197–98.

credits, arguing that tax credits more efficiently promote conservation and are unaffected by donor wealth or income.¹⁸⁴ Finally, Professor Roger Colinvaux suggests a refundable tax credit broken down into different tiers based on the level of restriction provided by the easement.¹⁸⁵

Refundable, capped tax credits fail to address the underlying problem with the current valuation system for three reasons. First, tax credits apply a fixed percentage to the before-value, reaching a value for the conservation easement that may be unrelated to the value of conservation achieved or cost to the taxpayer. The taxpayer is then incentivized to donate the minimum qualifying easement, maximizing the gap between the tax credit and the easement's actual value. While Colinvaux's tiered system is more nuanced, it merely reduces, rather than eliminates, this counter-productive incentive.

Second, tax credits fail to provide any offsetting reduction in administrative costs. In fact, requiring agencies to evaluate tax credit applications, necessary in a capped or tiered system, adds administrative costs to both the government and the applicant. Although costs to the IRS and the courts would undoubtedly decrease, it seems unlikely that agency review of each application would be cheaper than targeted litigation. Finally, a capped tax credit system would unnecessarily politicize conservation. Each time Congress considered a new budget proposal, the amount of conservation tax credits would become a budgetary issue. Tax deductions do not require any appropriations from Congress and are limited only by the public's appetite.¹⁸⁶

2. *Easement Qualification Regulation.*—If replacing the current deduction with a tax credit is undesirable, surely improvements can be made to curb abuse and limit litigation. Some have proposed making the conservation easement deduction more difficult to claim.¹⁸⁷ Presumably, taxpayers with more valuable easements or those more committed to the conservation cause will be more willing to overcome barriers to claiming the deduction. Further, the taxpayer is incentivized to increase the level of restriction in the easement to meet a higher qualification standard.

Historic preservation expert Jess Phelps recently advanced the simple proposition that conservation organizations should require more restrictive

¹⁸⁴ Wolf, *supra* note 21, at 329–30.

¹⁸⁵ Colinvaux, *supra* note 29, at 50–52.

¹⁸⁶ The current effort to reinstate the 2006 expanded benefits is instructive here. Despite widespread support, the initiative failed in 2013. If Congress were required to periodically review the conservation easement deduction, it is unlikely that it would be consistently renewed. *See supra* notes 33–35 and accompanying text. Also instructive is the Historic Tax Credit, currently under threat of repeal and a focus of the National Trust for Historic Preservation's lobbying efforts. *Historic Tax Credits*, NAT'L TRUST FOR HISTORIC PRESERVATION, <http://www.preservationnation.org/take-action/advocacy-center/policy-resources/historic-tax-credits.html> [http://perma.cc/9MYX-LEPN].

¹⁸⁷ McLaughlin, *supra* note 43, at 109; Phelps, *supra* note 25, at 161–62.

easements from their donors.¹⁸⁸ Phelps theorizes that if the taxpayer is currently at greater risk of deduction disqualification, conservation organizations can convince the taxpayer to donate a more restrictive easement whose valuation is more likely to be upheld.¹⁸⁹

Although this goal is laudable, it is also unrealistic. Just as with appraisers, taxpayers can shop around for a conservation organization that will accept the desired level of restriction or valuation.¹⁹⁰ Indeed, if cases like *Scheidelman* and *Graev* are any indication, at least one major conservation group is pursuing taxpayers for conservation easement donations that skirt the line of abuse.¹⁹¹ Further, increasing the required level of development restriction does not necessarily increase the likelihood that the valuation is correct. A more restrictive easement ostensibly results in a larger diminution in the property's value, so the taxpayer may actually feel entitled to a larger deduction.

Professor Nancy McLaughlin recently suggested that the IRS make available to taxpayers advance rulings on easement qualification and valuation.¹⁹² The taxpayer would first complete the easement donation and submit an appraisal to the IRS.¹⁹³ The IRS would then accept the appraisal or calculate its own valuation, binding the taxpayer to its decision.¹⁹⁴ But as McLaughlin admits, taxpayers would only pursue an advance ruling if the IRS could be trusted to reach a fair valuation.¹⁹⁵ Considering the number of previously cited cases where the IRS pursued a very low valuation or a valuation of zero, it seems unlikely that many taxpayers would pursue an advance ruling.

3. *Easement Valuation Restrictions.*—Other commentators have focused on restricting the amount of the deduction a taxpayer can claim, either through limits on valuation or limits on the deduction itself. Stephanie Jeane proposed, in response to the *Whitehouse* decision, that a fixed percentage be applied to the before-value of a property based on the loss of the rights to develop or to control the exterior of a historic building.¹⁹⁶ While Jeane's method only addresses facade easements, it would be a simple matter to devise a similar fixed percentage for open land easements or other conservation easements.

¹⁸⁸ Phelps, *supra* note 25, at 162–64.

¹⁸⁹ *Id.* at 163.

¹⁹⁰ See Novack, *supra* note 164. The IRS's lawsuit against the Trust for Architectural Easements also demanded the names of 800 easement donors. *Id.*

¹⁹¹ See Graev v. Comm'r, 140 T.C. 377, 381–87 (2013); *Scheidelman I*, 100 T.C.M. (CCH) 24, 24–25 (2010), *vacated*, 682 F.3d 189 (2d Cir. 2012); see also Novack, *supra* note 164.

¹⁹² McLaughlin, *supra* note 43, at 91.

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ Jeane, *supra* note 128, at 513–16.

Jeane acknowledges that such a proposal places administration efficiency above accuracy.¹⁹⁷ Some taxpayers would donate minimally restrictive easements and receive a windfall, while other taxpayers would be discouraged from donating high-value easements because the full value would not be captured. When Jeane applied her own method to the *Whitehouse* properties, the result was a value below the finding of the court and far below that claimed by the taxpayer.¹⁹⁸ Determining a fixed percentage that would apply fairly to even a majority of conservation easements would seem to be an impossible task. Generally, rules—as opposed to standards—are less effective where the objects of regulation are more dissimilar from each other.¹⁹⁹ Because of the extreme variability in both property and easements characteristics, attempting to replace the current standard-based system with a rule-based system (especially one so simple) would inevitably lead to extreme inequities.²⁰⁰

Alternatively, Kate Deal suggests capping the value of conservation easements that could be accepted by a land trust each year, based on a multiplier of annual cash donations received.²⁰¹ Because a conservation easement requires a donee as well as a donor, limiting land trusts' (the organizations holding and enforcing the easements) acceptance of donations theoretically limits the overall number of donations. Deal theorizes that the land trust's desire to accept as much conservation easement value as possible each year would pressure the donor to submit a reasonable, or even low, valuation.²⁰² She further argues it would shift much of the cost of qualification and valuation enforcement from the IRS to land trusts, which are perhaps better qualified to assess conservation purpose and easement value.²⁰³ Presumably, competition among donors and land trusts would further develop the conservation easement market.²⁰⁴

As Deal acknowledges, land trusts with large cash resources might consistently fail to meet the cap and not be incentivized to effectively police easement valuations.²⁰⁵ For example, the standard practice of the Trust for Architectural Easements, a group criticized by the IRS,²⁰⁶ is to request a cash donation in conjunction with a donated easement.²⁰⁷ The

¹⁹⁷ *Id.* at 516.

¹⁹⁸ *Id.* at 509, 516.

¹⁹⁹ Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 600 (1992).

²⁰⁰ *See id.* at 591 (“[T]he simple rule is both over- and underinclusive compared to the more complex standard.”).

²⁰¹ Deal, *supra* note 18, at 1611–17.

²⁰² *Id.* at 1613.

²⁰³ *Id.* at 1615.

²⁰⁴ *Id.* at 1612.

²⁰⁵ *Id.* at 1616.

²⁰⁶ Novack, *supra* note 164.

²⁰⁷ *Program Q&A*, TRUST FOR ARCHITECTURAL EASEMENTS, <http://architecturaltrust.org/easements/program-qa/> [<http://perma.cc/Y6BS-YRYG>].

cash donations are used to enforce the easements held by the Trust.²⁰⁸ This arrangement would permit the Trust to effectively avoid any cap as every donation would increase their ceiling.

Deal suggests that if abuses recur, the IRS could resort to revoking a land trust's tax-exempt status.²⁰⁹ Indeed, the IRS recently succeeded in obtaining an injunction against the Trust for Architectural Easements for what the IRS alleged was a scheme encouraging overvaluation of conservation easements.²¹⁰ Although the success of the injunction in preventing abuse remains to be seen, the IRS surely spent a large sum on the lawsuit and the accompanying 300 audits.²¹¹ The IRS is now ten years into its campaign against abusive easement valuations, yet litigation (and its associated costs) continues apace.

Further, incentives between the donor and the donee would become misaligned. Land trusts would have the incentive to require high cash donations or undervalue easements to fit more under the cap, in direct conflict with the taxpayer's (legitimate) desire to maximize the tax benefit of a donation. However, the burden of identifying and litigating abuse is likely then to shift to the taxpayers, who are surely far less equipped to combat undervaluation abuse than the IRS is to combat overvaluation. This is not to say that land trusts will at all act maliciously, but not aggressively pursuing the maximum donation may be grounds for a taxpayer challenge. Both Jeane's and Deal's proposals have the ultimate effect of shifting the litigation burden away from the IRS and to the taxpayer.

B. "Alternative Minimum Value" Is a New Way Forward

Current proposals do not adequately address the conservation easement valuation problem without introducing countervailing costs that outweigh their benefits. Further, a deduction (or credit) program based solely on market valuation is imprecise, prone to abuse, and fails to capture conservation benefits accruing to the community. But without flexible valuation, some taxpayers will receive windfalls, while others will be discouraged from donating valuable easements.

To avoid many of these valuation problems and better promote conservation, I propose the implementation of what I term "alternative minimum valuation." Under this proposal, when a taxpayer claims the conservation easement deduction, she may elect to either claim an easement value backed by an appraisal (as the current system permits) or

²⁰⁸ *Id.*

²⁰⁹ Deal, *supra* note 18, at 1616–17.

²¹⁰ Press Release, U.S. Dep't of Justice, D.C. Fed. Court Bars Co. from Promoting Alleged Tax Scheme Involving Improper Easements on Historic Buildings (July 18, 2011), available at <http://www.justice.gov/opa/pr/dc-federal-court-bars-company-promoting-alleged-tax-scheme-involving-improper-easements> [<http://perma.cc/5XTP-7T33>].

²¹¹ See Novack, *supra* note 164.

choose the alternative minimum valuation. The alternative minimum value would be equal to a small fixed percentage of the before-value of the property. This minimum value provides a basic level of compensation to the taxpayer for donating a conservation easement while avoiding the costs and uncertainty of valuing the easement. By making alternative minimum valuation an election, the taxpayer is still free to claim a larger donation, provided she can justify that valuation through the current process.

The fixed percentage applied would be a small percentage, both to prevent abuse and to reflect the principle advanced in *Evans v. Commissioner* that every conservation easement provides some minimum level of restriction and probable loss to the taxpayer.²¹² Alternative minimum valuation would thus capture value at two points where, as previously discussed, the market fails to do so: the value of perpetual protection against possible changes in existing laws and regulations, and the positive externalities that accrue to neighboring properties and surrounding communities. Alternative minimum valuation ensures some compensation to the taxpayer for providing those benefits.

Application of a fixed percentage to determine an easement's value is not a new concept. Although the Tax Court has repeatedly rejected the use of a predetermined rate in valuation,²¹³ even the IRS recognizes a typical range and has used that range to determine which taxpayers to audit.²¹⁴ At least three authors have recently recommended the use of fixed percentages.²¹⁵ However, applying a fixed percentage based even on the low end of typical donations, such as 10%, would undoubtedly result in a windfall to those who donate minimally qualified easements and provide a strong incentive for abuse.

Alternative minimum valuation would use a much smaller fixed percentage, high enough to capture the minimum benefits of a donation, but low enough to avoid windfalls and abuse. Rather than attempt to determine that percentage myself, I propose the IRS convene a panel of conservation experts to determine what minimum percentage should be applied. This panel would be similar to one proposed by Professor McLaughlin, modeled after the successful Art Advisory Panel and a 1987 Treasury proposal.²¹⁶ Unlike McLaughlin's panel, which would promulgate comprehensive

²¹² 100 T.C.M. (CCH) 275, 279 (2010) ("We note that ordinarily any encumbrance on real property, howsoever slight, would tend to have some negative effect on that property's fair market value. Even a nominal encumbrance that is placed by the current owner of the property would, at the very least, deprive a subsequent owner of the opportunity of placing a similar encumbrance on that property.").

²¹³ *Scheidelman III*, 105 T.C.M. (CCH) 1117, 1121 (2013), *aff'd*, 755 F.3d 148 (2d Cir. 2014) (citing *Nicoladis v. Comm'r*, 55 T.C.M. (CCH) 624, 629 (1988)).

²¹⁴ See *Scheidelman I*, 100 T.C.M. (CCH) 24, 26 (2010), *vacated*, 682 F.3d 189 (2d Cir. 2012) (citing an early-2000s IRS training manual).

²¹⁵ Colinvau, *supra* note 29, at 38; Jeane, *supra* note 128, at 514–15; Wolf, *supra* note 21, at 329.

²¹⁶ McLaughlin, *supra* note 43, at 89–90.

valuation standards, this panel would only be tasked with determining an appropriate minimum percentage. The panel should have the freedom to determine different percentages for different classes of property, such as open land or historic buildings, as the minimum considerations are likely different.

Use of alternative minimum valuation would also decrease administrative, litigation, and deficiency costs to the IRS while providing the taxpayer the opportunity to claim the deduction at a much lower risk of challenge. The IRS could focus its efforts more acutely on those deductions that are truly abusive, rather than merely difficult to value, and relieve the Tax Court of conducting lengthy valuations of their own.²¹⁷ The taxpayer would also avoid the cost of appraisal, often several thousand dollars. The reduced cost and improved certainty would open up the conservation easement tax deduction to less wealthy individuals and spread its adoption as a tool of conservation.

In many cases, the value of the conservation easement would be significantly greater than the alternative minimum valuation. Successful valuations typically range from 10%–15% of the property's before-value.²¹⁸ Alternative minimum valuation would permit the taxpayer to instead claim the larger deduction, if supported by a qualified appraisal in accordance with current regulations. Owners of high-value properties would thus remain encouraged to place substantially restrictive conservation easements. Of course, the valuation pitfalls remain, but at least the taxpayer can decide whether the value of the higher deduction is worth the risk of audit or litigation, rather than the all-or-nothing approach currently permitted. For less wealthy owners of properties that are still worth protecting, such as middle-class homeowners, the alternative minimum value is a quick and easy way to protect their land and get a deduction they might not otherwise deem worthwhile.

One point of concern with the use of alternative minimum valuation would be that taxpayers might donate illusory or deficient conservation easements to claim the minimum deduction. However, existing law already stipulates minimum characteristics that an easement must have if placed on a building in a registered historic district.²¹⁹ The IRS, perhaps through the advisory panel, could develop a set of minimum characteristics that a conservation easement must have to claim the alternative minimum valuation.²²⁰ Qualification standardization would also help less wealthy

²¹⁷ Though equipped to do so, the Tax Court has previously discouraged the IRS from using the courts as a forum for hashing out valuation disputes. *Id.* at 86.

²¹⁸ See *Scheidelman II*, 682 F.3d 189, 196 (2d Cir. 2012) (noting the validity of evidence, including an out-of-print IRS publication, in the taxpayer's appraisal showing a typical range of 10%–15%).

²¹⁹ 26 U.S.C. § 170 (h)(4)(B) (2012).

²²⁰ For historic buildings, this could be as simple as requiring compliance with the Secretary of the Interior's Standards for the Treatment of Historic Properties. See *Secretary of the Interior's Standards*

taxpayers more easily claim the deduction. And because alternative minimum valuation is an election, taxpayers would be free to find other ways to structure easements, subject to the stricter valuation process currently in place. In the event that taxpayers pursue alternative easement structures, the existence of a clear framework would help the IRS better identify abuse and help taxpayers justify deviations from the norm, smoothing or even reducing litigation.

Some might argue that even if minimum qualifications were set, taxpayers might still claim easements that do not truly provide protection because of overlap with existing law.²²¹ Indeed, the IRS has expressed strong opposition to the use of the fixed percentage method for largely this reason.²²² But as previously discussed, conservation easements provide a benefit of perpetuity, protecting a property even if laws change or are repealed in the future. However, if the IRS (or advisory panel) continued to find the perpetuity benefit to be too small or too speculative, the minimum characteristics could include a provision that the easement must substantially restrict development in a manner not currently prohibited by law.²²³ Although such a rule might crowd out properties located in historic districts, those property owners could still pursue the deduction without the alternative minimum valuation election.

Others might argue that a deduction should only reflect what the taxpayer donated, ignoring external benefits accrued by the conservation easement. This argument is hardly unique to conservation easements, however, as the tax code is commonly—perhaps, increasingly—used to effect policy changes through tax deductions, credits, or penalties in lieu of direct spending or fining.²²⁴ Opposition on these grounds speaks to a larger debate on the efficiencies of the tax code. But if compensating taxpayers for the creation of positive conservation externalities begets greater positive externalities, why shouldn't this behavior be encouraged?²²⁵

for the Treatment of Historic Properties, NAT'L PARK SERVICE, <http://www.nps.gov/tps/standards.htm> [<http://perma.cc/P2BM-K76R>].

²²¹ See, e.g., *Mountanos v. Comm'r*, 105 T.C.M. (CCH) 1818, 1821 (2013) (finding that state and federal law precluded taxpayer's claimed use).

²²² Karin Gross, IRS Office of Chief Counsel, Remarks in *Trying Times: Important Lessons to be Learned From Recent Federal Tax Cases Involving Conservation Easements* (May 20, 2014) (audio recording on file with the American Bar Association Real Property, Trust & Estate Law Group).

²²³ Such a rule would not be uncharted territory for the IRS or the courts. See *Kaufman v. Shulman*, 687 F.3d 21, 32 (1st Cir. 2012) (remanding a property located in a local historic district for consideration of valuation and commenting favorably on the ability of the IRS to craft regulations that "curtail dubious deductions in historic districts where local regulations already protect against alterations" without "stifling Congress' aim to encourage legitimate easements").

²²⁴ Cf., e.g., *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2600 (2012) (upholding the Affordable Care Act's individual mandate as a tax).

²²⁵ The aforementioned *Whitehouse*-derived hypothetical is instructive here. In such a situation, the taxpayer's donation is valueless to the taxpayer, yet valuable to the surrounding historic district. Under

Alternative minimum valuation reflects the reality that the flexibility of the current valuation system is necessary, yet is unable to effectively capture conservation value or avoid abuse on its own. Allowing taxpayers the choice of alternative minimum valuation provides the proper incentives for conservation easement donations, makes the deduction more accessible to nonwealthy individuals, and reduces the significant costs of IRS policing and taxpayer risk. Further, wealthy individuals and high-value property owners, who are likely to be more sophisticated donors, will be free and better able to evaluate the trade-off between the risks and rewards inherent in the two options.

Finally, alternative minimum valuation is preferable to other proposals because of the simplicity of implementation. Alternative minimum valuation can be integrated into the valuation scheme with the simple passage of a single Treasury regulation. While qualified appraisals are defined by statute,²²⁶ valuation is left to Treasury regulations and publications, which can be altered without Congressional approval.²²⁷ A tax credit program would require comprehensive federal legislation, and significant modifications of the current valuation regime would require passage of several complex regulations. Once the IRS determined the fixed percentage to be used, implementation of alternative minimum valuation would be comparatively easy.

CONCLUSION

As many commentators have noted, the current system of valuing conservation easements is broken. Appraisals are costly, inaccurate, and do little to protect the taxpayer from deficiencies and penalties or the IRS from abuse. The IRS has challenged many conservation easement deductions recently, resulting in the Tax Court settling questions of valuation and taxpayers seeing significant penalties. This broken system undermines the goals of the conservation easement deduction program and threatens to curb conservation efforts.

To resolve many of these problems, I propose that the taxpayer be permitted to claim an alternative minimum valuation, applied as a small fixed percentage to the before-value of the property. By giving the taxpayer an option to pursue a streamlined, low-cost way to claim the conservation easement deduction, taxpayers can more easily and cheaply participate in the program, costs of enforcement and valuation to the IRS and the Tax

my proposal, rather than lose out on the benefits of the easement, the historic district (through the federal government) is effectively paying the donor small compensation for a larger benefit.

²²⁶ 26 U.S.C. § 170(f)(1)(E) (2012).

²²⁷ See Treas. Reg. § 1.170A-13 (as amended in 1996); Treas. Reg. § 1.170A-14 (as amended in 2009); see also *Conservation Easement Audit Techniques Guide*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Conservation-Easement-Audit-Techniques-Guide> (last revised Jan. 3, 2012) [<http://perma.cc/9UAJ-P9CC>].

Court will drop, abuse will be curbed, and the deduction will better reflect the conservation value that the market fails to capture. Adoption of alternative minimum valuation will further incentivize adoption of conservation easements and become a valuable tool for conservationists.